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SENSITIVE BUT UNCLASSIFIED - PLEASE PROTECT ACCORDINGLY

¶1. (U) SUMMARY: Viewed through the lenses applied by many business groupings, Brazil's "competitiveness" has been falling relative to its major emerging market peers, such as India and China. Numerous surveys of business leaders and some studies, including by the OECD, show Brazil falling in various competitiveness rankings. While there is no settled definition of what constitutes a country's "competitiveness" -- indeed, it is a concept which some economists believe to be flawed -- these surveys/studies do highlight a common set of problems with Brazil's business environment and investment climate. These include: a high tax burden, onerous tax compliance requirements, excessive bureaucracy, insufficient infrastructure, middling economic growth prospects, corruption, convoluted labor legislation, high real interest rates and a lack of investment in education and innovation. The reforms called for by these studies and surveys are legion, but tax reform stands out as a particular need. END SUMMARY.

IS BRAZIL A MAJOR EMERGING MARKET?

¶2. (SBU) The term BRIC (Brazil, India, Russia, and China) was first coined by investment bank Goldman Sachs in a 2003 paper asserting that these rapidly developing economies may eclipse most developed markets by 2050. Since then, BRIC has entered into popular usage to refer to these four countries and their status as the leading large developing economies. Although Brazil since 2003 has made measurable progress in many areas, particularly debt management and

efforts to improve the functioning of financial markets, its GDP growth has looked paltry in comparison to India, China and Russia. Growth in the four years of the Lula administration is expected to average 2.86 percent. Although better than the 2.34 percent achieved under former president Fernando Henrique Cardoso (FHC) from 1995 to 2002, it stands in sharp contrast to recent Chinese averages of close to 10 percent and India's of around 6 percent. World Bank figures show Russia's yearly growth since 2000 at around 7 percent. An early 2006 article in the "Economist" magazine on the importance of emerging markets showed three countries, represented as animals, circling the globe: a dragon for China, an elephant for India, and a bear for Russia. Brazil was notably absent. Regarding Brazil's absence, newspaper columnist and former Finance Ministry official Roberto Macedo commented, "Perhaps the artist just couldn't think up an animal to represent Brazil. But a monkey would be appropriate. Either way, it's time for Brazil to choose its own mascot before it's too late and we end up with a donkey, a sloth, or even a beached whale."

COMPETITIVENESS SURVEYS

¶3. (U) HUMPTY DUMPTY: Brazil slipped 8 places to 65th in the World Economic Forum's (WEF) 2005 - 2006 Global Competitiveness Survey, which represents business leaders' opinions on competitiveness in 117 countries. Brazil's fall from 57th to 65th was among the largest slide of any country. Breakout data showed more surprising figures. Brazil was 79th in macroeconomic environment, ranked just below Nigeria. It was 81st in macroeconomic stability and 83rd with regard to inflation. It was second to last in terms of interest rates. And Brazil was dead last in the efficiency of its tax system. On the positive side, the study showed a low terrorist

threat index for Brazil, but its "cost of crime" index was among the worst in the world. In terms of education, Brazil is in 97th place in the quality of its public schooling. In terms of potential for growth, Brazil was 65th in the opinions of these business leaders, beaten out by Ghana and Kazakhstan. The WEF report emphasized that it is not enough for Brazil to merely maintain its solid macroeconomic management. "If a country wants to be competitive, it needs to be vigilant and attack on various [reform] fronts. The government needs to respond quickly to important problems like education, infrastructure, and labor," said Augusto Lopez-Claros, Chief WEF Economist.

¶4. (U) PERCEPTION OF CORRUPTION UP: According to the WEF, the ongoing corruption scandals, allegedly involving influence peddling and vote-buying in Congress by members of the Lula Administration, sullied the image of the public sector with a one-two punch: undermining private sector confidence and distracting legislators from the important task of preparing the Brazilian economy for competition in the global marketplace. The WEF ranking indicates that the largest slide occurred in business leaders' perceptions of the quality of public institutions. In this category, Brazil slid 20 places to 70th. According to the study, government inefficiency is one of the major obstacles to business in Brazil. With regards to the use of public funds, Brazil occupied one of the lowest slots, 111th. It ranked 62nd in terms of government corruption and 69th in terms of favoritism in government decisions. Professor Carlos Arruda, Director of Development at the Dom Cabral Foundation and coordinator for the WEF study in Brazil, made the following observation: "Last year, whn we announced the results, we expected that Brazl would gain in the rankings on the strength of it sound macroeconomic policies. But we fell in te rankings due t the private sector's loss of cnfidence in public institutions. For 2006, it'surgent that we find a solution to Brazil's institutional crisis." Arruda confirmed that countries eperiencing institutional crises have historicall felt negative impacts on the macro and microecoomic fronts. Business leaders had better perceptins of the level of corruption in China and India, which placed 49th and 50th places respectively. Russia came in 75th.

AN INTEMPERATE INVESTMENT LIMATE

¶5. () FROSTIER THAN DENMARK: According to the Busines Climate Ranking released in March by the Economist Intelligence Unit (EIU), Denmark will maintainthe best business climate between 2006 and 2010 (it was also first from 2001 through 2005). Brazil, however, slipped three places to 45th among 60 countries. The EIU's global business rankings model is applied to the world's 60 largest countries, which account for more than 95 percent of global output, trade, and FDI. It measures the quality and attractiveness, adjusted for country size, of the business environment and its key components. The model considers 70 factors across 10 categories important to business life, including political and institutional environment, macroeconomic stability, approach to entrepreneurs, foreign investment, funding, and infrastructure.

¶6. (U) CHILLY FORECAST FOR FDI: According to the Organization for Economic Cooperation and Development (OECD), this all adds up to an unattractive investment climate. Per OECD Secretary General Donald Johnson, "The USD 18 billion that Brazil received in foreign investment in 2004 was more a function of the size of the country than of an attractive and favorable investment climate. In Brazil, much remains to be done." Johnson noted that with appropriate

reforms, Brazil could overtake China as the number one destination for investment in emerging markets. In 2004, Brazil received three percent of foreign direct investment (FDI), whereas China received 10 percent of FDI. Johnson specifically mentioned improvements in the tax environment, citing Brazil's "overwhelming tax burden. It's not that Brazil has a hostile investment climate, but with regulatory reform and advances in Private Public Partnerships (PPPs), Brazil could receive much more than its already impressive USD 18 billion per year," said Johnson. He continued, "Structural reforms need to be made so that the entire country can benefit from globalization." This is also reflected in A.T. Kearney's 2003-04 FDI Confidence Index (which measures 25 countries in terms of their attractiveness for FDI), wherein Brazil fell eight places. By comparison, in A.T. Kearney's 1998 study Brazil was the second most attractive country on the list; today it is 17th.

DIAGNOSIS: PAUCITY OF INVESTMENT IN INNOVATION
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¶7. (U) LOW PATENT COUNT: Brazil trails behind China, India, and Russia in the field of research and innovation, according to a recent study by the World Intellectual Property Organization (WIPO). The WIPO study showed that Brazil registered fewer international patents than the other three BRIC nations in 2005 and ranked 27th overall out of 128 countries. In 2005, Brazil registered only 238 patents with WIPO, an increase of 0.07 percent, or two patents, over the previous year. Russia registered 500 patents with WIPO in 2005. China increased its WIPO patents by 47 percent, with 2,452 registered in 2005, up from 1,706 in 2004. And India registered 648 patents with WIPO last year. The WIPO ranking is one gauge of a country's investment in innovation.

¶8. (U) PRESCRIPTION FOR INNOVATION: Brazil has a longstanding problem with moving university-based research, in which it does invest, out of the lab and into industry. Concrete approaches to the problem, however, only came into being recently, first with the advent of a Patent Law in 1997, next with the establishment of sector funds for innovation and development in 1999, then with the introduction of the 2004 "Innovation Law," and most recently with Provisional Measure 252, passed last year, offering tax incentives to businesses that invest in technical innovation. The government's hope is that these measures, in particular the changes introduced by the innovation law, will help to merge research from universities and public institutions with business and industry.

¶9. (SBU) Whether the Innovation Law will indeed enable Brazil to generate the research and investment needed to create wealth is an open question. That measure encourages the public and private sector (particularly small and medium-sized enterprises) to share staff, funding and research facilities. However, it takes a government-centric approach, charging newly-created federal, state and municipal agencies with management of the entire innovation system, i.e. selecting parties for technology licensing, helping to

arrange terms for exclusive licensing for commercial exploitation, and ensuring that licensed technology is commercially exploited "in the public interest." Once an invention or new procedure is created, instead of having the relevant innovation support agency step back from the process, the law contemplates that this entity would acquire a partial share - as opposed to ceding title in full to private industry. Officials at one of the country's leading research incubation centers have told us that while the concept of an innovation law is nice, given the heavy government involvement (and, ironically enough, the lack of implementing regulations), they

had no plans to take advantage of the law's provisions and would proceed on their own.

¶10. (U) For others, greater cooperation between academia and industry is not really the solution. One of the principal symptoms of weak industrial innovation in Brazil is the size of qualified workforce with advanced degrees dedicated to research and development. According to Carlos Henrique de Brito Cruz, Scientific Director of FAPESP (Sao Paulo Research Foundation), "In Brazil, there is a mistaken assumption regarding the place of research in the university system. In industrialized countries, more than half of research is conducted in the industrial sector, not at universities. And this industrial research generates 90 percent of all patents." For example, in South Korea, the developing country with the largest number of WIPO patent registrations, of 124,000 professionals in the research sector, 60 percent are employed in industry. In Brazil, only 18 percent are in industry. Moreover, in Korea, 64 percent of those in industrial research have masters and/or doctoral degrees. In Brazil, only 14 percent have graduate degrees. Brazil's weak showing in international patent registrations is a symptom of broader problems in Brazil's ailing innovation sector.

PRECIOUS PRODUCTIVITY

¶11. (U) REDUCED POTENTIAL: Taken together, these business challenges redound in lower growth potential. A report released in April of this year by Brazil's National Confederation of Industries (CNI) shows Brazil falling to second-to-last (22nd) place in productivity rankings of the 23 largest economies. Between 2001 and 2005, Brazil increased its average productivity by 1.3 percent, down from 6 percent between 1996 and 2000 (when Brazil ranked 4th) and also down from 7 percent between 1991 and 1995 (when it ranked 6th). Italy, with negative growth, came in at last place in the CNI ranking. According to the study, India experienced the greatest average yearly growth in productivity at 10.1 percent. CNI points to Brazil's low productivity growth as a warning sign for future exports, saying, "A great part of our recent export growth is attributable to productivity gains during the 1990s; low productivity growth tends to compromise future export growth." CNI attributes Brazil's decline in productivity to high interest rates and low investment. The group advises that in order to regain productivity growth and secure future export growth, Brazil needs to raise its investment levels, especially investment in technological innovation. Unfortunately, according to recent rankings, Brazil's investment climate is unattractive.

THREE KEY REFORMS

¶12. (U) TAX REFORM: The American Chamber of Commerce (AmCham) advocacy agenda recently has focused on three key reforms: tax reform, regulatory agency autonomy and intellectual property protection. Brazil's infamously burdensome taxation system repeatedly has been cited by multinationals as the primary factor encouraging companies to draw down employment and/or move operations outside of Brazil. Brazil's taxation system engenders widespread tax evasion and helps stimulate the prevalent informal or shadow economy. According to AmCham, there are currently 40 measures within 27 different pieces of legislation that guide taxation of goods and services. Other items closely related to needed tax reform include: combating tax evasion, encouraging businesses to

enter the formal economy, and designing a better way for businesses to receive proof of tax credits with the federal government.

¶13. (U) REGULATORY AUTONOMY: Brazil's young regulatory agencies are in many cases struggling to find their feet. For the last three years, AmCham has been working to influence policy-makers regarding the role of Brazil's principal regulatory agencies -- the food and drug administration-equivalent (ANVISA), the Electric Energy Agency (ANEEL), the National Telecommunications Agency (ANATEL), and the Council on Fair Competition (CADE)). AmCham studies also point out that frequent changes in the regulatory framework legislation are problematic for long term investments, particularly in energy and infrastructure. Furthermore, AmCham's most recent evaluation of ANVISA faulted its lack of internal norms regarding decisions (resulting in uncertainty when applying for pharmaceutical licensing, for example); its inefficiencies in the use and integration of information technology (contributing to ANVISA's average 5-year backlog for permit approval); its lack of internal training for permit-approving officials; and the absence of any measures to reduce its processing time. A pharmaceutical executive at Eli Lilly remarked, "We have commercial operations in more than 140 countries. When Eli Lilly decides to invest, ANVISA's inefficiencies weigh against our investing here in Brazil."

¶14. (SBU) INTELLECTUAL PROPERTY PROTECTION: Internationally, concerns about Brazil's intellectual property protection have dampened the enthusiasm of some investors. To its credit, Brazil has done much over the last two years to improve its copyright protection, in part due to concerns over potential USG revocation of Brazil's Generalized System of Preferences (GSP) benefits. The GSP review, while shining a spotlight on copyright issues, failed to motivate similarly significant changes on the patent and trademark front. While the GoB is working to improve the performance of the National Patent Institute (INPI), which has a tremendous backlog of unprocessed patent applications, the effort is nascent (ref C). Much remains to be done to emphasize the benefits of a strong patent and trademark regime, especially in terms of attracting high-technology investment and spurring innovation.

BRAZIL: COMPETITIVE IN INEQUALITY

¶15. (U) THE RICH-POOR GAP PEER GROUP: Brazil has long fared poorly in global rankings of income equality, such as the World Bank's World Development Index, frequently rating among the world's five worst countries alongside the likes of the Central African Republic, Sierra Leone, and Swaziland. The United Nations 2005-2006 Human Development Index estimates that in Brazil, the richest 20 percent claim 85 cents out of every dollar earned, while the poorest 20 percent earn 3 cents, leaving 12 cents to the middle 60 percent of the population. Moreover, according to a February 2006 publication by the World Bank entitled "Poverty Reduction and Growth: Virtuous and Vicious Circles," Brazil's highly concentrated wealth can limit growth potential by negatively impacting on such areas as education levels, longevity, skilled labor, and innovation. The World Bank study also tied inequality to competitiveness, and stated that only with an active policy of reducing inequality can Brazil achieve sustained growth. Stating further that Brazil will only be able to catch up and compete with China and the Asian "tigers" if it combats poverty in a more aggressive manner, the World Bank report linked key reform issues, such as access to credit and capital for the poorer classes, to the alleviation of poverty and inequality.

COMMENT

¶16. (SBU) Although Brazil is heading in the right direction, its pace leaves something to be desired. Part of this is a question of emphasis. By contrast with some of its major emerging market competitors, Brazil has invested time and resources over the past

twenty-two years in building up its democratic institutions. These often do not engage in economic reforms with tremendous speed, but they do give the system legitimacy. The institutionalization of the fiscal responsibility law is a useful example. But Brazil must do better if it is to address entrenched poverty and reduce inequality and if its institutions are to maintain legitimacy. An important first step will be addressing the twin issues of fiscal and tax reform during the first year of the new administration, to be elected in October 2007. END COMMENT.

¶17. (U) This cable was coordinated with Embassy Brasilia.

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